FAMILY BUSINESS, ACCOUNTING CONSERVATISM AND EARNINGS INFORMATIVENESS

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1.0 INTRODUCTION

Accounting conservatism and earnings informativeness are important elements in good quality financial reporting (Ball, Robin, & Wu, 2003; Beekes, Pope, & Young, 2004; Fan & Wong, 2002). Accounting conservatism requires a higher degree of verification for recognizing good news as gains than bad news as losses in financial statements. This implies that bad news is recognized as losses more quickly than good news as gains. Accounting conservatism is an effective mechanism to address agency problems. Agency problems arise due to the separation of ownership and control of firm operations, whereby managers have the incentives to take measures to transfer wealth to themselves. As accounting conservatism understates earnings and net assets, it reduces the ability of managers to take actions for their own benefit. Greater accounting conservatism is expected to be observed in firms when separation of ownership and control is greater (Lafond & Roychowdhury, 2008; Watts, 2003). Earnings informativeness refers to the extent earnings recognize information that is incorporated in stock prices. It is measured by earnings and stock returns relationship. A strong earnings and stock returns relationship is expected when firms produce high quality earnings.

Existing studies indicate that accounting conservatism and earnings informativeness are associated with good corporate governance. For example, Beekes et al. (2004) report that board structure with strong corporate governance mechanism is associated with accounting conservatism. They show that firms with higher proportion of outside directors are associated with higher accounting conservatism. Ahmed and Duellman (2007) find that accounting conservatism is negatively related to the percentage of inside directors on the board, and accounting conservatism is positively related to the

percentage of outside directors' shareholdings. Vafeas (2000) reports that earnings informativeness is higher for firms with smaller boards. In a related study, Bushman et al. (2004) show that boards tend to adopt stronger corporate governance mechanism when earnings informativeness is low.

The objective of this paper is to examine the association between ownership structure and accounting conservatism and earnings informativeness. Ownership structure is an area of research that remains unsettled. For example, Fan and Wong (2002) and Ball et al. (2003) document that low financial reporting quality is due to concentrated ownership. However, recent studies indicate that concentrated ownership is associated with high financial reporting quality. Wang (2006) reports that family firms are inclined to report high quality financial information. They are not likely to engage in opportunistic behaviour in reporting earnings as it could damage the families' reputation. The result is supported by Ali, Chen and Radhakrishnan (2007) who find that family firms report higher earnings quality than non-family firms. Similarly, in Malaysia, Wan Nordin (2009) finds that family firms are also associated with high corporate transparency.

Specifically, in this paper we examine accounting conservatism and earnings informativeness for family firms and non-family firms. In family firms, owners control the operations of the firms. Therefore, agency cost is expected to be less severe in family firms. Lafond and Roychowdhury (2008) show that accounting conservatism is negatively related with managerial ownership. Based on the finding and the agency theory, it is expected that the level of accounting conservatism to be lower for family firms than it is for non-family firms. The quality of financial

reporting of family firms is often regarded as of low quality. This is due to entrenchment effect whereby it is believed that owners take measures for self-interest purpose. However, recent studies (Ali, Chen, & Radhakrishnan, 2007; Wan Nordin, 2009; Wang, 2006) indicate that the quality of financial reporting of family firms is not of lower quality than that of non-family firms. Instead, findings suggest that the quality of financial reporting for family firms is higher than it is for non-family firms. Hence, based on recent findings, we expect that earnings informativeness is higher for family firms than it is for non-family firms. Using a sample of Malaysian firms for the period 2000-2007, we find that both family firms and non-family firms recognize bad news as losses more quickly than good news as gains. The results suggest that accounting conservatism exists in both family firms and non-family firms. Our results also show that there is no difference in the level of accounting conservatism between family firms and non-family firms. With respect to earnings informativeness, we find that the association between earnings and stock returns is stronger for family firms than for non-family firms.

The rest of the paper proceeds as follows. Section 2 reviews prior studies and develops the hypotheses. Section 3 discusses the research method and Section 4 presents the results. Section 5 is the conclusion.

2.0 PRIOR STUDIES AND HYPOTHESES DEVELOPMENT

2.1 Ownership Structure

The ownership structure determines the distribution of power between managers and shareholders. The concentration of ownership would be beneficial to firms as large shareholdings allow for greater monitoring of managers (Jensen & Meckling, 1976).

Thus, the absence of separation between ownership and control reduces conflicts of interest and increases shareholder value (Morck et al., 1988).

In East Asian countries, firms are usually controlled by families or the State. Control is obtained primarily through the use of pyramids and participation in management (La Porta et al., 1999). A study by Claessens et al. (2000) in nine East Asian countries (Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Thailand and Taiwan) reports that more than two thirds of the firms are controlled by a single shareholder. About 60% of concentrated firms' top management is related to the family of the controlling shareholder and there is extensive family control in more than half of East Asian firms. Yammeesri and Lodh (2004) study 243 non-financial firms listed on the Stock Exchange of Thailand for the period 1993-1996. They find that firms with controlling ownership have higher performance than those with non-controlling ownership. Results also show that family-controlling ownership has a positive and significant relationship with firm performance.

The ownership structure of many Malaysian firms is concentrated and the shares are held by the state, families or individuals (Zhuang, Edwards & Capulong, 2001). Reports on the Observance of Standards and Codes (ROSC) by the World Bank indicate that 67.2% of the shares of Malaysian firms are owned by family members; 37.4% of the shares are owned by controlling shareholders and 13.4% of the shares are state controlled. A study by Hui (1981) find that 0.8 % of shareholders own 69% of the total shares of the 62 largest Malaysian firms during the period 1974-1976. La Porta et al. (1998) evidence that 54% of ownership is owned by the three largest owners who are from the ten largest Malaysian non-financial listed companies. The

findings by Hui (1981), La Porta et al. (1998) and Zhuang et al. (2001) demonstrate that Malaysian firms have a high degree of ownership concentration. A survey conducted by PricewaterhouseCoopers (1998) shows that almost 97% of Malaysian private limited companies (PLCs) are substantial shareholders[1] with 33% of them involve in management. Abdullah (2001) find that the single largest shareholder holds 36% of the firm's shares. Che-Ahmad et al. (2003) study 236 PLCs and find that the block-holders hold 60.75% of shareholdings. A study by Abdullah and Mohd-Nasir (2004) determine that the average shareholding by the top 20 shareholders is 73%. Tam and Tan (2007) claim that concentrated ownership affects firm performance. Firm characteristics such as firm age, size and sector also influence firm performance. A study by Zainal Abidin et al. (2009) also shows that directors in Malaysia have sizeable ownership stakes in the company compared to their counterparts in Western economies such as Sweden and the UK (Ho & Williams, 2003). This is perhaps due to the higher number of family-owned and managed companies in Malaysia.

2.2 Family Firms

Family firms have special characteristics that distinct themselves from non-family firms. In family firms, ownership is concentrated and managerial ownership is high. The management mainly consists of family members and board of director is less open to outsider (Corbetta & Montemerlo, 1999). Family spirit is strong in family firms whereby, it serves as a monitoring and controlling mechanism (Fama & Jenssen, 1983). Moreover, family traits influence the governance of family firms (Mishra, Randoy & Jenssen, 2001). The involvement of family members in the management allows them to have extensive knowledge in the operations of the firms.

[1] A substantial shareholder is defined as having at least 5% (direct or indirectly) of the aggregate of nominal amounts of all the voting shares in the firm as defined in Section 69D, Companies Act 1965.

Consequently, family members are able to make flexible, timely and efficient decision makings (James, 1999). In addition, the presence of family members in the management benefits family firms in term of lower cost of debt, and therefore family firms are more likely to maximize shareholders' values (Anderson, Mansi & Reeb, 2003).

Agency cost is expected to be less severe for family firms compared to non-family firms. Agency cost arises due to the separation of ownership and control. However, as family members control the operations of the firms, they become dominant and entrenched. According to entrenchment effect, owners are more likely to engage in transactions that benefit themselves. As owners have control on firms' financial reporting, they have the incentives and the opportunities to manage accounting numbers for self-interest purpose. Consequently, investors do not trust reported earnings as they expect owners manipulate earnings, and hence, this undermines the credibility of earnings and lowers earnings informativeness (Fan & Wong, 2002). It is also argued that family firm structure produces low quality financial reporting. This is due to the fact that debt tends to be private for family firms. Capital requirement is usually financed by bank loans. Information asymmetry more likely is resolved by private communication. Therefore, there is no demand for high quality financial reporting (Ball et al., 2003).

However, recent studies document that family firms are associated with high quality financial reporting. Wang (2006) argues that due to the entrenchment effect, users of financial statements demand family firms to produce high quality earnings. Family firms are concerned with families' reputation. Therefore, they have the incentives to

report earnings of high quality in order to protect the families' reputation. Wang examines the quality of earnings for S&P 500 firms and finds that earnings are more informative for family firms. Ali et al. (2007) contend that family firms acknowledge that market is aware of their activities and therefore they are not inclined to engage in activities that benefit themselves. They are concerned that market might penalize their rent seeking activities in the form of lower equity value. Accordingly, family firms have the incentive to produce high quality earnings. Ali et al. find that earnings of family firms are of higher quality than that of non-family firms. In a related study, Wan Nordin (2009) examines whether family firms are associated with greater corporate transparency. He reports that corporate transparency is higher for family firms than it is for non-family firms.

2.3 Accounting Conservatism and Earnings Informativeness

Accounting conservatism recognizes economic losses immediately in the financial statements, but it requires higher verification standards for recognition of economic gains. Accounting conservatism is a good element of high quality financial reporting (Ball et al., 2003). It is argued that accounting conservatism is an effective mechanism to reduce agency cost as it curbs managers' opportunistic behaviour. It reduces the ability of managers to overstate earnings and net assets (Watts, 2003). Furthermore, accounting conservatism discourages managers to invest in negative NPV projects or poorly performing investments as they are unable to defer recognition of losses to the future (Ball & Shivakumar, 2005).

Beekes et al. (2004) examined the level of accounting conservatism between firms with a higher proportion of outside directors and firms with fewer outside directors.

Corporate governance for firms with a higher proportion of outside directors is regarded as superior than that for firms with fewer outside directors. Beekes et al. find that accounting conservatism is higher for firms that have good corporate governance mechanisms. Firms with a higher proportion of outside directors recognize losses on a timelier basis than firms with fewer outside directors. Ahmed and Duellman (2007) obtain similar results. They report that accounting conservatism is high for firms with high percentage of outside directors' shareholdings. For firms with high percentage of inside directors' shareholdings, accounting conservatism is low. Ball and Shivakumar (2005) argue that the governance structure and monitoring mechanisms are different between private and public firms. Thus, difference in accounting conservatism between private and public firms is expected. Ball and Shivakumar report that accounting conservatism is lower for private firms than that for public firms. Ball et al. (2003) use accounting conservatism as a measure for financial reporting quality in examining the quality of financial reporting. They found that the quality of financial reporting is not determined solely by the quality of accounting standards. Instead, institutional structure is more important that it provides incentive for the preparer of financial statements whether to produce high or low quality financial reporting.

Lafond and Roychowdhury (2008) relate the level of accounting conservatism with ownership structure. Agency cost is more severe when the interests of managers and shareholders are less aligned. Lafond and Roychowdhury argued that accounting conservatism is employed in firms when the interests of managers and shareholders are less aligned in order to curb agency cost. Therefore, it is expected that the demand for accounting conservatism is higher when managerial ownership is low. They show

that accounting conservatism is high when managerial ownership is low and accounting conservatism is low when managerial ownership is high.

In family firms, ownership is concentrated and managerial ownership is high. Based on Lafond and Roychowdhury's (2008) finding, it is expected that accounting conservatism to be lower for family firms compared to non-family firms. Therefore, we hypothesize that:

H_1: The level of accounting conservatism for family firms is lower than it is for non-family firms.

Earnings informativeness refers to the extent earnings recognize information that is incorporated in stock prices. A strong relationship between earnings and stock returns is regarded as high quality financial reporting. Many previous studies measure earnings informativeness to assess the quality of financial reporting. Lev and Zarowin (1999) examine the quality of financial reporting in the U.S over the twenty year period from 1977 to 1996. They report that over the period, earnings informativeness has declined suggesting a deteriorating in the quality of financial reporting. Ball, Kothari and Robin (2000) adopt the same measure to examine the quality of financial reporting between common-law countries and code-law countries. They find that financial reporting in common-law countries is of higher quality. Vafeas (2000) documents that earnings informativeness is high for firms with good corporate governance mechanisms. Earnings are more informative for firms with effective board structure. The results indicate that earnings and stock returns relationship is

greater for firms with small board of directors, which is regarded as more effective than large board of directors.

Wang (2006), Ali et al. (2006) and Wan Nordin (2009) document that financial reporting of family firms is of higher quality than that of non-family firms. Based on the evidence, we hypothesize that:

H_2: Earnings informativeness is higher for family firms than it is for non-family firms.

3.0 RESEARCH METHOD

3.1 Sample Selection

We gather the data from the company annual reports and financial database. The company annual reports are retrieved from the Bursa Malaysia website (www.bursamalaysia.com). The financial data is retrieved from the Thomson Advance Database. We use a sample of family firms and non-family firms listed on the Main Board of Bursa Malaysia.[2] We adopt the definition of family firm and non-family used by Amran (2011). A firm is classified as a family firm when the following criteria are met: (1) CEO is the founder or the successor who is related by blood or marriage, (2) at least two family members hold management position in the company, and (3) family directors have a minimum of 20% interest (direct and indirect shareholding) in the company. Firms classified under the finance sector, unit trusts and REITS are excluded because of their unique features and business activities

[2] In August 2009, the Main Board and the Second Board of Bursa Malaysia merged, and known as the Main Market of Bursa Malaysia.

as well as differences in compliance and regulatory requirements. Our final sample consists of 2,856 firm-year observations over the period of 2000-2007.

3.2 Measurement Model

We use Basu's (1997) measure as our measure of conservatism. Basu defines conservatism as earnings capture bad news faster than good news. Using stock returns to proxy for good and bad news, Basu expects that in a reverse regression of earnings on stock returns, a higher association of earnings with negative stock returns than with positive stock returns would be observed. Basu's regression model is as follow:

$$E_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 D_t R_t + \varepsilon_t$$

where E_t is annual earnings deflated by the beginning of period market value, R_t is a twelve-month stock return, D_t is a dummy variable that equals one if stock return is negative and equals zero otherwise, and ε_t is the residual term. The coefficient β_3 measures the sensitivity of earnings to bad news and it is expected to be positive and significant when earnings are more sensitive to bad news than to good news.

We extend the Basu (1997) model to include the dummy variable for family firms to examine the difference in accounting conservatism between family firms and non-family firms. The estimating equation is as follow:

$$\begin{aligned} EARN_t = {} & \beta_0 + \beta_1 NEG_t + \beta_2 RET_t + \beta_3 NEG_t . RET_t + \beta_4 FAMILY_t \\ & + \beta_5 NEG_t . FAMILY_t + \beta_6 FAMILY_t . RET_t + \beta_7 NEG_t . FAMILY_t . RET_t \\ & + \varepsilon_t \end{aligned}$$

where $EARN_t$ is annual earnings deflated by the beginning of period market value, NEG_t is a dummy variable that equals one if stock return is negative and equals zero otherwise, RET_t is a twelve-month stock return, $FAMILY_t$ is a dummy variable that equals one for family firm and equal zero otherwise, and ε_t is the residual term. In the model, β_3 captures the sensitivity to bad news for non-family firms, while β_7 captures the marginal effect of sensitivity to bad news for family firms.

We predict that the level of accounting conservatism is lower for family firms than it is for non-family firms. Therefore, it is expected that β_7, coefficient on $NEG.FAMILY.RET$, is negative and statistically significant.

Following Vafeas (2000) and Fan and Wong (2002), earnings informativeness is measured by earnings and stock returns relationship. We include the dummy variable for family firms to examine the difference in earnings informativeness between family firms and non-family firms. The estimating equation is as follow:

$$RET_t = \beta_0 + \beta_1 FAMILY_t + \beta_2 EARN_t + \beta_3 FAMILY_t.EARN_t + \varepsilon_t$$

where RET_t is a twelve-month stock return, $FAMILY_t$ is a dummy variable that equals one for family firm and equal zero otherwise, $EARN_t$ is annual earnings deflated by the beginning of period market value, and ε_t is the residual term. β_2 measures the sensitivity of stock returns to earnings for non-family firms, while β_3 measures the marginal effect of sensitivity of stock returns to earnings for family firms.

We predict earnings informativeness to be higher for family firms than it is for non-family firms. Therefore, it is expected that β_3 to be positive and significant.

4.0 RESULTS AND DISCUSSION

Table 1 reports descriptive statistics for regression variables. Stock returns have a minimum value of -0.90 and the maximum value of 5.26. Stock returns are right-skewed where mean value of 0.09 is higher than median value of 0.00. The minimum value and the maximum value of earnings are -25.32 and 22.17, respectively. Earnings are left-skewed where mean value of 0.03 is lower than median value of 0.09.

Table 1
Desriptive Statistics for Regression Variables

	Mean	Median	Standard Deviation	Upper Quartile	Lower Quartile	Minimum	Maximum
Stock Returns	0.09	0.00	0.58	0.27	-0.25	-0.90	5.26
Earnings	0.03	0.09	1.02	0.15	0.01	-25.32	22.17

Table 2 reports the regression results for accounting conservatism. Model 1 examines the sensitivity of earnings to good news and bad news for all sample firms. The coefficient for good news, β_2, is 0.17 and statistically significant at a 1 percent level. The differential slope coefficient for bad news, β_3, is 0.34 and statistically significant at a 5 percent level. The results indicate that earnings are more sensitive to bad news than to good news. The sensitivity of earnings to bad news is 3 (= [0.17 + 0.34] / 0.17) times greater than that for good news. Hence, the results suggest that accounting

conservatism exists for family firms and non-family firms, which indicates high quality financial reporting.

Table 2
Regression Model for Accounting Conservatism between Family and Non-family Firms

$$EARN_t = \beta_0 + \beta_1 NEG_t + \beta_2 RET_t + \beta_3 NEG_t . RET_t + \beta_4 FAMILY_t + \beta_5 NEG_t . FAMILY_t + \beta_6 FAMILY_t . RET_t + \beta_7 NEG_t . FAMILY_t . RET_t + \varepsilon_t$$

Variable	β	Model 1 (n=2,856)	Model 2 (n=2,856)
CONSTANT	β_0	-0.03 (0.435)	-0.7* (0.075)
NEG	β_1	0.18*** (0.002)	0.24*** (0.001)
RET	β_2	0.17*** (0.000)	0.22*** (0.000)
NEG. RET	β_3	0.34** (0.016)	0.38** (0.023)
FAMILY	β_4		0.16** (0.033)
NEG. FAMILY	β_5		-0.22* (0.090)
FAMILY. RET	β_6		-0.19* (0.073)
NEG.FAMILY.RET	β_7		-0.18 (0.590)

*Significant at 1% level, **Significant at 5%, ***Significant at 10%.
(figures in the parentheses are the p-values)

Model 2 examines the sensitivity of earnings to good news and bad news for family firms and non-family firms. β_3 measures the sensitivity to bad news for non-family firms, while β_7 measures the marginal effect of sensitivity to bad news for family firms. The differential slope coefficient on β_3 is 0.38 and statistically significant at a 5 percent level. The differential slope coefficient on β_7 is -0.18. However, it is not

statistically significant. The results indicate that there is no difference in the sensitivity of earnings to bad news between family firms and non-family firms. The evidence suggests that there is no difference in the level of accounting conservatism between family firms and non-family firms. Therefore, the result is not consistent with our expectation.

There have been conflicting evidence pertaining to the quality of financial reporting of firms with different ownership structure. Earlier studies (such as Fan and Wong, 2002; Ball et al., 2003) document that firms with concentrated ownership produce low quality financial reporting due to entrenchment effect. Furthermore, there is no demand for high quality financial reporting as information asymmetry is resolved through private communication. Recent studies (such as Wang, 2006; Ali et al.,2007), however, suggest that family firms, which have concentrated ownership, produce high quality financial reporting to protect firms' reputation as well as to avoid negative market valuation. Our results support the latter. There is no evidence to support that the quality of financial reporting, as measured by accounting conservatism, of family firms is less superior than that of non-family firms. It appears that family firms are now concerned with the quality of financial reporting.

Table 3 reports regression results for earnings informativeness for non-family firms and family firms. β_2 measures the sensitivity of stock returns to earnings for non-family firms, while β_3 measures the marginal effect of sensitivity of stock returns to earnings for family firms. The slope coefficient on β_2 is 0.04 and statistically significant at a 1 percent level. The differential slope coefficient on β_3 is 0.09 and statistically significant at a 10 percent level. The results indicate that the sensitivity of

stock returns to earnings is greater for family firms. Stock returns for family firms are 3.25 (= [0.04 + 0.09] / 0.04) more sensitive to earnings than non-family firms. Therefore, the results confirm our expectation that earnings informativeness is higher for family firms than it is for non-family firms. As far as earnings informativeness is concerned, the results in Table 3 provide evidence that the quality of financial reporting for family firms is of higher quality than it is for non-family firms.

Table 3
Regression Model for Earnings Informativeness for Family and Non-family Firms

$$\boldsymbol{RET_t = \beta_0 + \beta_1 FAMILY_t + \beta_2 EARN_t + \beta_3 FAMILY_t.EARN_t + \varepsilon_t}$$

Variable	$\boldsymbol{\beta}$	
Constant	β_0	0.08***
		(0.000)
Family	β_1	0.02
		(0.427)
EARN	β_2	0.04***
		(0.000)
FAMILY.EARN	β_3	0.09*
		(0.087)

*Significant at 1% level, **Significant at 5%, ***Significant at 10%.
(figures in the parentheses are the p-values)

Our results are consistent with the earlier studies (Wang, 2006; Ali et al., 2006; Wan Nordin, 2009) that show family firms produce higher financial reporting quality than non-family firms. It appears that there is a change in market valuation toward the quality of financial reporting of family firms. Previously, investors regard the financial reporting as of low quality and they put less emphasis on the information in setting stock prices. However, investors now regard the financial information provided by family firms is of higher quality than that provided by non-family firms.

5.0 CONCLUSION

In this paper we examine accounting conservatism and earnings informativeness for family firms and non-family firms. Accounting conservatism and earnings informativeness are important elements in good quality financial reporting. Using a sample of Malaysian public listed firms during the period 2000-2007, we find that there is no difference in the level of accounting conservatism between family firms and non-family firms. With regard to earnings informativeness, we find that earnings informativeness is higher for family firms than it is for non-family firms. The empirical results suggest that the quality of financial reporting of family firms is not of lower quality than that of family firms. Instead, the empirical result suggests that investors value earnings information reported by family firms higher than that reported by non-family firms. Interestingly, our study provides evidence to support recent studies (Wang, 2006; Ali et al., 2007; Wan Nordin, 2009) that document family firms are associated with high quality financial reporting.

In 2007, Malaysian Code of Corporate Governance was revised with the aim to strengthen the board of directors and audit committees, and to ensure that the board of directors and audit committees discharge their roles and responsibilities effectively. It is likely the revision in corporate governance code to result in better financial reporting quality. Further research is necessary to understand the impact of the revision in corporate governance code on family firms' financial reporting quality.

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